



# Small Company Coalition

Universal Broadband Service Proposal

April 2014

# Discussion Points

- SCC Goal
- FCC Stated Goals & Objectives
- Plan Proposed Goals
- Intercarrier Compensation Considerations
- Conceptual Framework
- Mechanics
- Capping Mechanism
- Case Study
- Other Considerations



## SCC Goal

*“Create an explicit, efficient and fair funding mechanism that incents the deployment of broadband networks and the transition to IP networks while providing carriers with revenues that are sufficient to enable recovery of capital and operating costs, including a reasonable return on investment, incurred to provide universal broadband services to rural consumers at rates and conditions comparable to those charged to consumers in urban areas.”*



# FCC Stated USF Goals

The FCC stated the following guiding principles in the *USF/ICC Transformation NPRM*:

- Modernize USF to include broadband
- Fiscal Responsibility – create efficiency in the program to control the size of the USF
- Accountability
- Incentive-based policies: proper incentives for carriers to invest in broadband technologies should be created



# FCC Objectives

Subsequent FCC Orders indicate additional concerns:

- Universal Support Funds should have a total cap
- Rural consumers should pay their fair share
- Support to individual companies/areas should be equitable
- Uneconomic funding and improper incentives should be avoided
- USF reforms should reflect the fundamental shifts in technology, consumer behavior, and competition



# Plan Proposed Goals

- No Retroactive Rulemaking: Ensure Rate-of-Return (RoR) carriers have the opportunity to recover properly incurred capital and operating costs incurred prior to date certain
- No Unfunded Mandates: Funding for new investment must be commensurate with any obligations imposed
- Predictable and Sufficient Funding: Any new broadband recovery mechanism should clearly define how funding for new investment will be recovered and ensure funding is sufficient to recover the cost to be supported under the plan
- Understandable Mechanisms: Any proposed industry plan should be transparent, relatively simple in concept and mechanics, and quantifiable as to impacts on carriers
- Comparable and Affordable Services for Rural Consumers. The plan should seek to ensure rural areas have access to broadband at terms, rates and conditions comparable to urban areas within the budget parameters of the universal service fund



# Intercarrier Compensation

- To be clear, this is a USF-only proposal
- While voice traffic will never go away completely, it is declining [generally] at a rate of 5% - 15% annually
  - Nonetheless, networks are not being used less, but instead are being used more than ever
  - Of course IP and bandwidth is replacing TDM and voice traffic at an alarming rate



# Conceptual Framework

The SCC Universal Broadband Service proposal consists of the following four components:

- The Broadband High Cost Loop Fund. This addresses a comprehensive solution solely for RoR carriers. The Fund provides support for the deployment of broadband services as well as current voice telephony services. Support is based on actual costs and calculated through a modified high cost loop model. The Broadband High Cost Loop Fund would effectively replace both the current High Cost Loop Fund and Quantile Regression Analysis methodology for RoR carriers in that it provides cost recovery of legacy investment; support for ongoing operating costs; and funding for new broadband investment



# Conceptual Framework

- Rate of Return Carrier-Specific Funding. The model develops an “RACPL” (Rate of Return Average Cost Per Loop) by state. This allows the Commission to analyze on a state by state basis the “outliers” participating in the fund, which creates a trigger for possible additional review, oversight, and inquiry. This trigger will help curtail fraud, waste, and abuse while requiring companies to adhere to reasonable spending limits and also provide attestations that they are in compliance with FCC rules. This trigger can also help the Commission by providing evidence toward the goal of offering 100 Mbps broadband speeds upon reasonable request by the year 2020



# Conceptual Framework

- The Broadband High Cost Loop Recovery Adjustment. The SCC recognizes that interstate broadband equipment included in 47 CFR Part 36 categories is currently recovered through interstate special access charges. Consequently, an adjustment to the calculation of special access charges is needed to avoid duplicate and excessive cost recovery. The proposed Broadband High Cost Loop Fund algorithm would allow the identification and quantification of support attributed to the broadband equipment categories. This amount is reduced from the 47 CFR Part 69 interstate special access rate element and added to the Broadband High Cost Loop Fund in a manner similar to the way line port costs are shifted in the MAG adjustment. The proposed adjustment would result in decreased rates for broadband services charged to consumers by reducing the subject revenue requirement. Specifically, consumers in rural America (via lower and more competitive end user prices); the National Exchange Carrier Association (“NECA”, via lower tariffed rates); and carriers on their own tariff would benefit under the new model since the recovery adjustment compensates carriers from the CAF and directly offsets costs/revenue requirements currently included in the Part 69 special access rate element



# Conceptual Framework

- Support would only be available to 1) build-out to customers without adequate availability to broadband service from a competitor; and/or 2) maintain a broadband-centric network, thereby insuring efficient use of fund resources
  - The term “adequate availability” would be determined by the Commission on a periodic basis (i.e., annually, biannually, etc.) in light of technological advances and the needs for broadband service by rural Americans



# Mechanics of SCC Proposal

- The SCC's USF reform proposal works similar to the previous HCLS algorithm, but includes broadband-centric cost study categories that now result in cost recoveries via CAF-related broadband funding. The following list briefly describes the model and its abilities:
  - Rate-of-return is based off of cost recovery, which the model uses as its premise
  - Cost causation: 86-111; 64-901(b); Part 36.2 – All support the concept of cost-causation
  - The model incorporates Parts 32, 36, and 69 into its algorithm



# Mechanics of SCC Proposal

- The model incorporates broadband Separations categories
- The model computes additional incremental CAF received, and correspondingly offsets Part 69 special access revenue requirements, which reduces pressure on NECA's (and others) tariff and also reduces end user rates
- The model works with a capped or uncapped fund



# Mechanics of SCC Proposal

- All companies are on a level playing field with the model, each having equal opportunity to invest and receive corresponding reimbursement, creating predictability
- The model is able to quantify support and provides stable funding
- With the model, if a company invests reasonably and not excessively, it is incentivized through cost recovery from the CAF; if a company opts not to invest, its costs are not recoverable from the CAF



# Mechanics of SCC Proposal

- The model accommodates various types and all sizes of ILECs (Co-ops; Tribal; Privately-Held; Municipalities)
- The model will accommodate corporate expense threshold limitations
- The model recognizes and accommodates the ideas that reforms should a) reflect the fundamental shifts in technology, consumer behavior, and competition; and b) create proper incentives for carriers to invest in broadband technologies
- The model efficiently leverages an existing explicit support mechanism with a limited transition period required
- Possibly apply an equitable metric to capture reasoning for high cost (access lines per square mile)??



# Capping Mechanism

- The SCC understands that a capped fund should assist in promoting fiscal responsibility
- The SCC offers two Capital Expenditure (“CapX”) alternatives in acknowledging that caps should be in place to not only avoid improper incentives but also create reasonable steps over time in aligning the “urban/rural” digital divide. Furthermore the SCC provides capping options for Operating Expenditures (“OpEX”)



# Capping Mechanism

## CapX Cap: Option #1

- Plant invested should be allowed based on a phased in approach to reach 100 Mbps to every home by 2020 (following is an example and not intended to be inflexible):
  - 4/1 by 12/31/14
  - 8/2 by 12/31/15
  - 16/4 by 12/31/16
  - 32/6 by 12/31/17
  - 64/12 by 12/31/18
  - 84/16 by 12/31/19
  - 100/20 by 12/31/20
- Amount of CapX necessary to reach these benchmarks should be attested to by an independent accredited engineer
- Pros
  - Can use form 481 as the tool to accomplish the phase in
    - ✓ “Deemed Reasonable” ideology
  - Provides for predictable and stable CapX allowances, which can feed into the SCC model to compute future funding levels by company
- Cons
  - Plant could depreciate more quickly than the allowable CapX, leading to rate base deterioration
- A reasonable approach may be to allow a minimum amount of CapX for normal/routine plant additions



# Capping Mechanism

## CapX: Option #2

- Concur and/or work with NTCA's plan. This plan currently includes a Capital Budget Mechanism, which is premised off of "accumulated depreciation and past investments made" metrics
- Another alternative could take NTCA's model and modify it to accommodate a standard FCC-allowed "depreciable life" metric, and use this to allow for consistency in the industry
- **Pros**
  - Allows for [what could be] significant CapX build out, reaching the FCC's "100 Mbps by 2020" goals with a high level of confidence
  - Creates some predictability
  - Allows for computed levels of projected support
- **Cons**
  - Allows for [what could be] significant CapX build out (creates more pressure on USF funding levels and creates allowances for investments)
  - State and/or Tribal-specific depreciation rates create mismatches in the amount of funding companies would be allowed to receive due to disparate depreciation rates nationwide



# Capping Mechanism

## Operating Expenditure (“OpEX”) Options

- Use 2013 accounting/cost levels to establish future allowances. Increase annually based upon GDP CPI; inflation; broadband connection increases; or combination
- Recognize that companies with older plant generally require more maintenance and upkeep on this plant. Using 2013 as a benchmark, create an incentive to allow for more immediate OpEX funding to get this plant modernized for the IP world. Phase-in caps would be necessary to transition older plant to newer plant in accordance with the CapX budget requirements, thus not allowing continued higher OpEX cost recovery on older plant based on a date-certain
- Access lines should NOT be used in benchmark and/or determination of funding levels as the sole variable. “Connections” (access lines and broadband combined), could/should be the variable used. Access lines are decreasing nationwide and allowances based upon this metric alone is unfair/unreasonable, inequitable, and counterintuitive to broadband deployment



# Capping Mechanism

## Trigger/NACPL

- In the SCC plan, a “trigger” is introduced if the FCC believes a company’s costs are excessive
- The trigger works such that, on a state-by-state basis, a “Rate of Return Average Cost Per Loop (RACPL)”, including standard deviations, is computed to determine if a carrier in the pool of companies significantly exceeds the state-specific RACPL. If so, the FCC has the option to review the company’s costs for reasonableness and/or request further information
- NACPL: to start, the National Average Cost Per Loop (NACPL) used in determining USF/CAF support utilizes the same process that the industry employs today



# Case Study \*\*: XYZ Telecom

## Assumptions:

- Used NACPL of \$605
- Included company-specific Part 36 Separations categories related to broadband (COE 4.11; COE 4.22; CWF Category 2)
- Used 2012 cost study and 13-1 annual HCLS filing

\*\* Actual company results



# Case Study: XYZ Telecom

XYZ Telecom					
Incremental CAF Funding Analysis					
Small Company Coalition Universal Broadband Model					
(HCL Recovery Adjustment: Incremental Broadband Categories; NACPL is \$605)					
	<u>Description</u>	<u>SCC Model</u>	<u>Legacy HCLS Model</u>	<u>Difference</u>	
HCLS Support	\$ 1,715,211	\$ 1,391,633	\$ 323,578		
NECA Settlements	\$ 397,573	\$ 514,757	\$ (117,184)		
Net Impact	\$ 2,112,784	\$ 1,906,390	\$ 206,394		
Notes:					
1) In this example, NECA settlements for all carriers decreases \$511M; tariff rates should decrease					
2) The offset is an increase in the CAF funding levels to now incorporate broadband; CAF funding increases to \$1.629B for all carriers					
3) To get CAF funding equal to legacy HCLS plus new broadband funding, NACPL needs to be approximately \$870. Doing so correspondingly decreases carriers' funding on a pro rata basis to effectively make the entire system a "wash"					
4) NECA has company-specific cost categories for total pool					



# Case Study Walk Through

- Current estimated HCLS fund size based on \$605 NACPL: \$730M
- HCLS estimated fund size including broadband Separations categories using \$870 NACPL: \$1.065B
  - \$870 NACPL necessary to control HCLS fund size ( using a \$605 NACPL increases the size of the HCLS CAF fund to ~ \$1.6B)
  - Using an \$870 NACPL generates ~ \$335M of additional CAF funding for broadband and also represents the incremental calculated difference between the current high cost loop algorithm and the new broadband high cost loop fund. This is therefore a “wash”
- Results:
  - NECA pool/interstate special access revenue requirement is reduced \$335M as an offset received from CAF funding
  - ILECs receive an additional \$335M in broadband-related CAF funding
  - Tariff rates decrease
  - End user prices decrease
- How will the incremental broadband funding get paid for??
  - See next slide...



# Other Considerations

A. Other Funding Mechanisms. In order to help alleviate pressure on the universal service funding mechanism, the Commission should consider implementing a methodology whereby the carriers responsible for building and maintaining the rural broadband network receive some form of compensation from all users of such network

- Expand contribution base
- Broadband “luxury tax”??
- Possibly “rate band” the FUSC charge??

B. \$250/Line/Month Cap: This cap should be discarded as the allowable level of funding decreases with access line losses. The “trigger” mechanism would effectively replace this rule instead of an automatic presumptive disallowance of funding

- Fully phased in as of 7/1/2014



# Questions?

James Kail, Executive Committee

[jjkail@lhtot.com](mailto:jjkail@lhtot.com)

Godfrey Enjady, Executive Committee

[genjady@matinetworks.net](mailto:genjady@matinetworks.net)

Glenn Lovelace, Executive Committee

[GLovelace@pvt.com](mailto:GLovelace@pvt.com)

Douglas K. Kitch, CPA

[doug@alexicon.net](mailto:doug@alexicon.net)

719-531-6342

